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IN THE

Supreme Court of the United States

October Term, [redacted] 1970

No. ____ [redacted] 235

STANLEY, INC.,

Petitioner,

vs.

PAUL A. SCHUSTER, District Director,
Internal Revenue Service,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

The petitioner, Stanley, Inc. (hereinafter, Taxpayer) respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit entered in this proceeding March 9, 1970.

OPINIONS BELOW

The opinion of the Court of Appeals is reported at 421 F. 2d 136 (1970) and is printed in the Appendix hereto at page 16. The opinion of the United States District Court for the Southern District of Ohio (Eastern Division) is reported at 295 F. Supp. 812 (1969) and is printed in the Appendix hereto at page 17.

JURISDICTION

The judgment of the Court of Appeals for the Sixth Circuit was entered on March 9, 1970. A timely petition for rehearing *en banc* was denied on March 31, 1970, and this petition for certiorari was filed within 90 days of that date. This Court's jurisdiction is invoked under 62 Stat. 928 (1948), 28 U.S.C. (1964 ed) §1254(1).

QUESTIONS PRESENTED

1. Did the Court of Appeals for the Sixth Circuit err in holding that the transfer of cash by Robert E. S. Young to the Taxpayer in exchange for Taxpayer's stock in 1958 and the purchase of land by Taxpayer from Turkey Run, Inc., in exchange for cash and a promissory note secured by a purchase money mortgage deed, in 1962 constituted Robert E. S. Young and Turkey Run, Inc. "in control" of the Taxpayer within the meaning of Sections 351(a) and 368(c) of the Internal Revenue Code of 1954 (26 U.S.C. (1964 ed) Sections 351(a) and 368(c)?

2. Did the Court of Appeals for the Sixth Circuit err in holding that the transfer of cash by Robert E. S. Young to the Taxpayer in exchange for the Taxpayer's stock in 1958, and the purchase of land by the Taxpayer from Turkey Run, Inc. in exchange for cash and a promissory note secured by a purchase money mortgage deed in 1962 met the requirement of Section 351(a) of the Internal Revenue Code of 1954 (26 U.S.C. (1964 ed) Sec. 351(a) that the transfer be "solely in exchange for stock or securities in such corporation"?

STATUTORY PROVISIONS INVOLVED

The statutory provisions involved are Sections 351(a) and 368(c) of the Internal Revenue Code of 1954. (26 U.S.C. (1964 ed) Secs. 351(a) and 368(c)). These statutes are printed in the Appendix at page 31.

STATEMENT OF THE CASE

References herein are to the Record as certified to this Court by the Court of Appeals for the Sixth Circuit which, pursuant to the agreement of the Petitioner and Respondent, consists of the agreed Appendix, filed with said court and printed in two volumes (Record-Transcript and Record-Exhibits, herein abbreviated R-T and R-E), and the record made in said Court of Appeals.

Appeals were taken to the Court of Appeals for the Sixth Circuit by both the Taxpayer and the Respondent. Respondent's appeal was dismissed June 24, 1969. Judgment of the Court of Appeals on Taxpayer's appeal was entered on March 9, 1970 affirming, by memorandum decision and without opinion, the opinion and judgment of the District Court. Jurisdiction was conferred upon the Court of Appeals by 72 Stat. 348 (1958), Title 28, U.S.C. (1964 ed) Sec. 1291.

Proceedings leading to this petition for certiorari were commenced in the Federal District Court, Southern District of Ohio, Eastern Division, by Taxpayer's claim for refund of federal income taxes for the year 1963 which were paid by the Taxpayer on December 20, 1965 in the total amount of $139,391.37 (including interest in the amount of $13,339.09).[1] Jurisdiction was conferred upon the District Court by 62 Stat. 932 (1948), Title 28, U.S.C. (1964 ed) Sec. 1340.

The facts may be summarized as follows:

Taxpayer was incorporated under the laws of Ohio on June 7, 1954 (R-E 1a). On August 12, 1958, five shares

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(1) Refund of $40,072.61 including taxes in the amount of $36,243.35 plus interest of $3,829.26 was ordered by the trial court after finding in the Taxpayer's favor upon issues not involved in this petition.

of stock of the Taxpayer were issued to Robert E. S. Young (consideration: $500.00) and on January 5, 1959, forty additional shares were issued to Robert E. S. Young (consideration: $4,000.00) (R-T 45a, 46a). Robert E. S. Young has at all times been the sole shareholder of the Taxpayer. (R-T 14a).

From the date of its formation, continuous efforts were made by the Taxpayer to locate and acquire suitable investment properties and in connection therewith it incurred binding obligations in the amount of $69,697.75.[2] (R-E 93a, 95a, 97a, 98a, 100a, R-T 39a-44a, R-T 100a.)

Turkey Run, Inc., was incorporated on October 7, 1947. Turkey Run, Inc., in exchange for 245 shares of Turkey Run, Inc. stock, acquired from Robert E. S. Young certain real estate including the tract of land containing 41.405 acres which later became known as "Greenfield Estates" (and herein called "Greenfield Estates") (R-T 15a).[3] Pursuant to his estate plan Robert E. S. Young commenced making gifts of his shares in Turkey Run, Inc. to his three children. (R-E 5a). Robert E. S. Young, by September 17, 1956 had reduced his holdings to one share of Turkey Run, Inc. which he continued to hold until January 2, 1963 when he gave this remaining share to his three children. (R-E 5a). From January 1, 1958 until December 31, 1965, Robert E. S. Young served as president and treasurer of Turkey Run, Inc. (R-T 18a-19a.)

On November 10, 1962, the Taxpayer agreed to purchase from Turkey Run, Inc. this tract of land, which

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(2) The trial court's decision that the Taxpayer sustained a *bona fide* loss of that sum under Sec. 165 of the Internal Revenue Code of 1954 (26 U.S.C. (1964 ed) Sec. 165) was not appealed.

(3) Unquestionably a Section 351 transfer.

was later known as "Greenfield Estates" at a cost of $6,000.00 per acre or a total cost of $248,430.00. (R-E 6a).

The Purchase and Sale Agreement by which the Taxpayer purchased "Greenfield Estates" (R-E 6a) *inter alia* required:

(1) payment to be made for "Greenfield Estates" as follows:

$ 1,430 on November 10, 1962, down payment
60,000 on November 10, 1963
60,000 on November 10, 1964
60,000 on November 10, 1965
67,000 on November 10, 1966

(2) said installments to be evidenced by a Promissory Note of the Taxpayer with an acceleration clause and with warrant of attorney to confess judgment (R-E 14a)

(3) said Promissory Note to be secured by a Mortgage (R-E 17a)

(4) said Mortgage to include an assignment of rents and profits and including consent to the appointment of a receiver for the real estate subject to the lien of said mortgage upon filing suit for forclosure of same. (R-E 17a).

The conditions of the Purchase and Sale Agreement set forth in paragraphs (1), (2), (3), and (4) above were satisfied by appropriate language in the Promissory Note (R-E 14a) and the Mortgage Deed (R-E 17a). The Mortgage Deed, which included in full the terms and conditions of the Promissory Note, was recorded in Vol. 2464, pg. 85 of the Mortgage Records in the office of the County Recorder, Franklin County, on November 20, 1962. Revenue stamps in the sum of $273.35 were affixed to the Warranty Deed conveying title to the Taxpayer and was recorded in Vol. 2441, pg. 513 of the Deed

Records in the office of the County Recorder, Franklin County, on November 20, 1962. (R-E 17a).

The Taxpayer made the payments, with the interest thereon, under its Promissory Note to Turkey Run, Inc. essentially according to the time schedule provided therein with the exception of the last payment due November 10, 1966 of which $17,000.00 had been paid in advance of the due date. The second installment was paid eight months in advance and the third installment had payments in advance aggregating $12,000.00 (R-E 126a, 128a, 129a; 130a, 131a, 133a, 134a). The balance due on the final installment would have been paid on its due date but for the payment by the Taxpayer of the subject assessment. (R-E 91a).[4]

As a separate and distinct transaction the Taxpayer borrowed from Turkey Run, Inc. (R-E 147a, 148a, 149a, 150a) the following sums in 1963 on the dates indicated: $5,000.—April 11; $40,000.—June 6; $15,000.—June 25. The total amount borrowed was repaid by the Taxpayer on October 23, 1963. (R-E 151a)

REASONS FOR GRANTING THE WRIT

The United States Court of Appeals for the Sixth Circuit by affirming the decision of the United States District Court for the Southern District of Ohio:

(1) has rendered a decision which is in conflict with other Courts of Appeal with respect to the meaning of "control" as used in Sections 351(a) and 368(c) of the Internal Revenue Code of 1954 (26 U.S.C. (1964 ed) Secs. 351(a) and 368(c));

---

(4) The balance due on note to Turkey Run, Inc., on the date Taxpayer paid the subject assessment of $139,391.37 including interest, (R-E 91a) was $60,000.

(2) has rendered a decision in conflict with this Court, with other Courts of Appeal, with the intention of Congress, and with prior decisions of the Sixth Circuit with respect to the policy and philosophy of Section 351, Internal Revenue Code of 1954 (26 U.S.C. (1964 ed) Section 351);

(3) has rendered a decision in conflict with this Court's opinion with respect to the disregard of the corporate entity;

(4) has passed upon questions arising under the tax laws of the United States, which opinion is contrary to a Regulation of the Treasury Department, and which vitally affects private enterprise;

(5) has proliferated the law as to distort Congressional intent and cast the law into a state of chaos so as to command the exercise of this Court's power of supervision.

ARGUMENT

References in this Argument to the lower court mean the Court of Appeals for the Sixth Circuit and the District Court for the Southern District of Ohio, Eastern Division since the Court of Appeals in affirming the District Court did so for the reasons set forth in the opinion of the District Court. (See Appendix page 16).

Section 351(a) of the Internal Revenue Code of 1954 (26 U.S.C. (1964 ed) Sec. 351(a)) provides for the non-recognition of gain or loss when there is: (1) an exchange by one or more persons which involves (2) the transfer of property by a transferor or transferors (3) to a corporation (other than certain specified corporations), (4) and thereafter the transferee is "controlled", as that term is defined by Sec. 368(c) by such persons (trans-

ferors), and (5) the receipt by them (transferors) of stock or securities of the transferee corporation.

In order to meet the requirement of Section 351 that the transfer be in exchange for a security, as well as the control requirement, the Court related the payment for stock in 1958 and its receipt by Robert E. S. Young in January 1959 to the receipt of the note and purchase money mortgage by Turkey Run, Inc. in 1962.

The lower Court "plowed virgin ground" by its transmutation of the two separate, distinct and unrelated transfers, separated by a time lapse of nearly four years, into a single transaction solely for the reason that the Taxpayer was thinly capitalized. (Appendix at page 25).

In *American Bantam Car Co. v. Comr.*, 11 T.C. Dec. 16,601 (1948) Affd. 177 F. 2d 513, (3rd C.A., 1949), Cert. denied 399 U.S. 920, 70 S. Ct. 622, *the Tax Court noted that to permit the petitioner a 15 month time lag after the exchange to determine control defeats the very language of the statute.*

The decision in *American Bantam Car Co.* (supra) comports with the declaration of the Internal Revenue Service as set forth in Internal Revenue Regulation §1.351-1 (a) (1) which states in pertinent part that the statute "*comprehends a situation where the rights of the parties have been previously defined and the execution of the agreement* [of transfer] *proceeds with an expedition consistent with orderly procedure.*"

The decision of the lower court in the instant case is clearly contrary to the meaning of the statute.

The lower court in reaching its conclusion that Robert E. S. Young and Turkey Run, Inc. were the transferors ignored the corporate entity of the Taxpayer while its conclusion that the Taxpayer sustained a tax recognized

loss as a result of its activities over essentially the same period of time, recognizes Taxpayer as a corporate entity.(5)

Justice Reed for the Supreme Court in *Moline Properties, Inc. v. Comr.*, 319 U.S. 436, 63 S. Ct. 1132 (1943), stated:

> "The doctrine of corporate entity fills a useful purpose in business life. Whether the purpose be to gain an advantage under the law of the state of incorporation or to avoid or to comply with the demands of creditors or to serve the creator's personal or undisclosed convenience, so long as that purpose is the equivalent of business activity or is followed by the carrying on of business by the corporation, the corporation remains a separate taxable entity. *New Colonial Ice Co. v. Helvering*, 292 U.S. 488, 494 (40-1 USTC Para. 9161). . . .
>
> . . . . In general, in matters relating to the revenue, the corporate form may be disregarded where it is a sham or unreal." (319 U.S. 436, 438-439).

There is a striking similarity between the provisions covering transfers to controlled corporations and the statutory provisions covering the alleged reorganization of the type involved in *Gregory v. Helvering*, 293 U.S. 465, 55 S. Ct. 266 (1934). (Merten's Law of Federal Income Taxation, Vol. 3, Sec. 46, pg. 128.) In *Gregory* this Court refused to recognize the reorganization saying:

> "To hold otherwise would be to exalt artifice above reality and to deprive the provisions in question of all serious purpose." (293 U.S. 465, 470)

The holding and reasoning of the lower court in the

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(5) Issue found in favor of the Taxpayer and not involved in this Petition.—see (R-T 33a-36a).

instant case serves as precedent for a holding that the "control" requirement of Sec. 351 is met by any transaction, except where a 100% cash payment is involved or a transaction in which the transferee has sufficient assets, without including the involved asset, to produce the income to meet the purchase payments. It is submitted that the lower court's holding is unrealistic in our present day credit economy and does in fact "exalt artifice above reality" and deprives the statutory provision in question of all serious purpose.

The theory and reasoning of the lower court's decision in the instant case is contrary to precedent in *Byerlite v. Williams*, 286 F. 2d 285 at pg. 291, (6th C.A., 1960), to the decision of the Court of Appeals for the Second Circuit in *Kraft Foods Co. v. Comr.*, 232 F. 2d 118 at pg. 128 (1956) and to the decision of the Court of Appeals for the Eighth Circuit in *J. S. Biritz Construction Co. v. Comr.*, 387 F. 2d 451 (1967). The position of the Court of Appeals for the Sixth Circuit, prior to the instant case, and the positions of the Courts of Appeal for the Second and Eighth Circuits were unanimous in their holding that respect should be accorded to the transactions between affiliated corporations *Byerlite (supra)*, sole shareholder and his corporation *Biritz (supra)* and *Kraft (supra)* unless there is no business purpose or the transaction is a tax-avoidance scheme or a sham or masquerade.

The Court for the Eighth Circuit in *Biritz (supra)* said:

> "We think the Tax Court has painted with too broad a brush in limiting the permissible activities of an entrepreneur in personally financing his business. Financing embraces both equity and debt transactions and we do not think the courts should enunci-

ate a rule of law that a sole stockholder may not loan money or transfer assets to a corporation in a loan transaction. If this is to be the law, Congress should so declare it. We feel the controlling principle should be that any transaction which is intrinsically clear upon its face should be accorded its legal due unless the transaction is a mere sham or subterfuge set up solely or principally for tax-avoidance purposes." (387 F. 2d 451, 459)

The Second Circuit in *Kraft Foods Co. (supra)*, in upholding the debt status of a parent-subsidiary transaction said:

"The Congress elected to tax legal entities as such, realizing that in a realistic economic sense affiliated corporations were but departments or branches of single enterprises. We think it is a necessary corollary of this Congressional choice that proper legal transactions among affiliates must be accorded tax recognition even though in a realistic economic sense they have limited significance. As Judge Learned Hand said, "* * * when a statute is drafted upon a concept like that of the reality of corporate personality, I do not see how that concept can fail to be determinative." *Sage v. Commissioner*, 2 Cir., 1936, 83 F. (2d) 221, 225 [36-1 USTC ¶9223].

Moreover, the controlling judicial decisions require recognition of the separate entities of affiliates and of financially sound transactions between affiliates. Where parent and subsidiary, as here, are true corporations conducting their respective businesses as holding company and as operating company, their intercorporate transactions must be accorded recognition unless in some way tainted." (232 F. 2d 118, 124)

. . . . The inquiry is not what the purpose of the

taxpayer is, but whether what is claimed to be, is in fact. As Judge Learned Hand said in *Loewi v. Ryan*, 2 Cir., 1956, 229 F. 2d 627, 629, * * * the Act is to be interpreted against its own background, and in deciding how far it adopted all legal transactions that the state law may have covered, it was proper to exclude those that had no other result than to evade taxation. The purpose of the Act was to exempt from tax only such legal transactions as arose out of an enterprise or venture that had some other authentic object of its own, and were neither alien and hostile to the raising of revenue, nor designed to effect no change in legal interests except to defeat a tax" (232 F. 2d 118, 128).

Only by concluding that Turkey Run, Inc., and Robert E. S. Young together were the transferors could the lower court reach the conclusion that the transferors were in control of the transferee (the Taxpayer), and its conclusion that Robert E. S. Young was a transferor was based on the inference that the Taxpayer-transferee was "thinly capitalized". The "thin capitalization" theory has been applied in many instances but never, even in its time of glory has it been extended to this extreme.

The exaltation of the "thin capitalization" criteria by the lower court conflicts with the decisions of the Courts of Appeal for the Fifth and Ninth Circuits and limits and discourages private enterprise.

We submit the following statements as evidence of the conflict which exists and which represent the judicial view which must prevail to encourage private enterprise in our present economy.

In *Rowan v. U.S.*, 219 F. 2d 51, (1955) the Court of Appeals for the Fifth Circuit said:

"It would obviously work an unwarranted interference by the courts in ordinary and perfectly proper

business procedures for us to say that there can be established, as a matter of hindsight, a ratio of stockholder owned debt to the capital of the debtor corporation. No stockholder could safely advance money to strengthen the faltering steps of his corporation (which, of course, may be greatly to the benefit of other creditors) if he is faced with the danger of having the Commissioner, with the backing of the courts, say, 'he had no right to launch a corporate business without investing in it all the money it needed, and investing it in the way that is most disadvantageous to himself, both as relates to taxation and as to other creditors.'

It is entirely within the competence of Congress to provide by statute for such ratio if it deems it advisable or necessary within the scheme of Federal taxation. It is not within our province to do so." (219 F. 2d 51, 55)

The Court of Appeals for the Ninth Circuit in *Estate of Herbert B. Miller*, 239 F. 2d 729 (1956) said:

"We know of no rule which permits the Commissioner to dictate what portion of a corporation's operations shall be provided for by equity financing rather than by debt. It is common knowledge that the choice of procedures in this regard will vary from corporation to corporation and we think that it cannot be said that any particular method of issuance of stock and incurrence of indebtedness can be labeled as "normal," and hence subject to approval by the Commissioner." (239 F. 2d 729, 734)

Further, the "thin capitalization" or stated otherwise, the debt-equity criteria is contrary to the underlying policy and philosophy of Section 351 (26 U.S.C. (1964 ed) Sec. 351). The policy of Section 351 was clearly expressed by Judge Magruder for the Court of Appeals

for the Second Circuit in *Portland Oil Co. v. Comr.*, 109 F. 2d 479, (1940) as follows:

> "It is the purpose of Section 112 (b) (5) [now Section 351] to save the taxpayer from an immediate recognition of a gain, or to intermit the claim of a loss, in certain transactions where gain or loss may have accrued in a constitutional sense, but where in a popular and economic sense there has been a mere change in the form of ownership and the taxpayer has not really 'cashed in' on the theoretical gain, or closed out a losing venture. As was said in *American Compress and Warehouse Co. v. Bender*, 70 F. (2d) 655, 657 (C.C.A. 5th, 1934), 'The transaction described in the statute lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating or extinguishing the beneficial interests of the transferors in the transferred property, after the consummation of the transaction the transferors continued to be beneficially interested in the transferred property and have dominion over it by virtue of their control of the new corporate owner of it.' " (109 F. 2d 479, 468)

The legislative history and other cases accord with this expression of the section's policy.[6]

CONCLUSION

Prior to the decision in the instant case, reconciliation of the decided cases under Section 351(a) and Section 368(c) was impossible. (Merten's Law of Federal Income Taxation, Vol. 3, Sec. 20.166, pg. 725. The instant case

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(6) See S. Rep. No. 275, 67th Cong., 1st Sess. 11 (1921), in 1939-1 Cum. Bull. 188-89. The 1954 Code made no change in the basic purpose of the section. See H. R. Rep. No. 1337, 83d Cong., 2d Sess. A 116 (1954); and Jordan Marsh Co. v. Commissioner, 269 F. 2d 453, 456 (2d Cir. 1959); Trenton Cotton Oil Co. v. Commissioner, 147 F. 2d 33, 36 (6th Cir. 1945); Clyde Bacon, Inc., 4 T.C. 1107, 1117 (1945).

cannot be soundly reconciled to any one of the heretofore irreconcilable cases.

Chief Justice Fred M. Vinson in an address to the American Bar Association in 1949 (69 S. Ct. v, vi) said that to remain effective, the Supreme Court must continue to decide only those cases which present questions whose resolution will have immediate importance far beyond the particular facts and parties involved. The case before the Court is such a case.

While there have been many cases decided in this area of transfers to controlled corporations, no clear rule has evolved for deciding whether a given transfer is governed by the nonrecognition provisions of Section 351 (26 U.S.C. (1964 ed.) Sec. 351). (University of Pennsylvania Law Rev., Vol. 114: 314 (1965)). A provision similar to Sec. 351, except for minor variations not pertinent here, has been in every revenue act since 1924. (Federal Income and Estate Tax Laws, 7th, 8th and 9th ed., Barton and Browning.) It is submitted that the lower court as well as certain other Courts of Appeal have so departed from the policy and philosophy of Sec. 351 that this Court should grant the writ prayed for so that the courts and Taxpayers may properly gauge what transactions will be treated as meeting the requirements for nonrecognition of gain or loss.

For the foregoing reason, this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

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Date: May 30, 1970.

APPENDIX

OPINION AND JUDGMENT OF THE UNITED STATES COURT OF APPEALS, SIXTH CIRCUIT

(caption omitted)

PER CURIAM ORDER

BEFORE: WEICK and COMBS, Circuit Judges, and McALLISTER, Senior Circuit Judge.

The above case coming on to be heard upon the record, the briefs of the parties, and the argument of counsel in open court, and the Court being duly advised:

Now, therefore, it is ORDERED, ADJUDGED and DECREED that the judgment be and is hereby affirmed for the reasons set forth in the opinion of Judge Joseph P. Kinneary.

ENTERED BY ORDER OF THE COURT:
/s/ CARL W. REUSS,
Clerk.

OPINION OF THE UNITED STATES DISTRICT COURT, SOUTHERN DISTRICT OF OHIO EASTERN DIVISION

(caption omitted)

MEMORANDUM OF DECISION

Plaintiff, Stanley, Inc., has brought this action under Title 28, United States Code, Section 1340, seeking a refund of federal income taxes which were paid by it as a taxpayer on December 20, 1965.

The facts of this case, as stipulated and as presented at trial, concern the activities of Stanley, Inc. during the years 1954 through 1963. The Commissioner of Internal Revenue assessed a tax deficiency against the taxpayer in the amount of $126,052.28 plus interest of $15,478.53 for the year 1963. Subsequently, $2,139.44 of the interest was abated. This assessment related to two principal issues. The first issue concerned the amount and nature of income realized by the taxpayer during the year 1963 from the subdivision, development and sale of lots in a housing development called Greenfield Estates. This issue in turn presented two questions; i.e., the basis of the land in the hands of the taxpayer and whether the income was ordinary income or capital gain. The second issue was whether the taxpayer was entitled to an abandonment loss during the year 1963 arising from an alleged abandonment of architectural plans for an apartment house complex which never developed.

I. INCOME FROM GREENFIELD ESTATES

A. The Basis of the Land in Hands of Taxpayer

Plaintiff contends that the deeding of the real estate,

later known as Greenfield Estates, by Turkey Run, Inc. to the taxpayer was a bona fide sale between the parties resulting in a stepped up basis for the land in the hands of the taxpayer. The defendant contends that the transfer was a Section 351 transfer resulting in a carryover basis in the hands of the taxpayer. Title 26, United States Code, Section 351, states as follows:

> No gain or loss shall be recognized if property is transferred to a corporation . . . by one or more persons solely, in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in Section 368(c)) of the corporation.

The relevant portion of Title 26, United States Code, Section 368(c) states:

> . . . the term "control" means the ownership of stock possessing at least 80 per cent of the total combined voting power of all classes of stock entitled to vote and at least 80 per cent of the total number of shares of all other classes of stock of the corporation.

In order for this transfer to fall within the provisions of Section 351, the transferor must be found, (a) to have transferred the real estate to Stanley, Inc. solely in exchange for stock or securities of Stanley, Inc., and, (b) to be in control of Stanley, Inc. immediately after that exchange.

The parties do not dispute the form of the transaction by which Turkey Run, Inc. transferred the land to Stanley, Inc. There was a purchase and sales agreement entered into by the parties calling for payment as follows:

Amount	Due Date
$60,000.00	November 10, 1963
60,000.00	November 10, 1964
60,000.00	November 10, 1965
67,000.00	November 10, 1966

Turkey Run, Inc. executed a warranty deed to Stanley, Inc., and a promissory note in the amount of $247,000.00 was executed in return.[1] The promissory note was secured by a mortgage deed which stipulated that the land was to be released from the mortgage only at the rate of one (1) acre per $6,000.00 paid on the note. Stanley, Inc. had been organized in 1954, but no stock was issued until 1958, and at the time of this transaction; i.e., 1962, Stanley, Inc. had assets totaling $99.84.

Though the form of the subject transaction was that of a sale, it is clear that substance, not form, controls in determining the effect of the transaction for federal income tax purposes. *Gregory* v. *Helvering*, 293 U.S. 465 (1935); *In re Kolkey*, 27 T.C. 37 (1956), *aff'd sub. nom. Kolkey* v. *Commissioner*, 254 F. 2d 51 (7th Cir. 1958). In *Kolkey*, the Tax Court established certain criteria for determining whether a transaction results in a "sale" or an "equity contribution."

> Was the capital and credit structure of the new corporation realistic? What was the business purpose, if any, of organizing the new corporation? Were the noteholders the actual promoters and entrepreneurs of the new adventure? Did the noteholders bear the principle risks of loss attendant upon the adventure? Were the payments of "principal and interest" on the notes subordinated to dividends and to claims of creditors? Did the noteholders have substantial control over the business

1. At the closing, $1,430.00 was paid in cash.

operations; and, if so, was such control reserved to them, as an integral part of the plan under which the notes were issued? Was the "price" of the properties, for which the notes were issued, disproportionate to the fair market value of such properties? Did the noteholders, when default of the notes occurred, attempt to enforce the obligations? *Burr Oaks Corporation* v. *C.I.R.*, 365 F. 2d 24, 27 (7th Cir. 1966) quoting *Kolkey, supra.*

Plaintiff contends that the facts of this case when tested under the above criteria demonstrate that the transaction between Turkey Run, Inc. and Stanley, Inc. was a "sale" and not a transfer in exchange for stock or securities. Reduced to the simplest of terms, the question becomes one of whether the subject transaction created a debtor-creditor relationship or a stockholder relationship between the transferee and transferor.

As stated above, the transaction took the form of a sale. The purchase and sale agreement set forth a payment schedule, demanded a promissory note, with acceleration clause and warrant of attorney, and demanded a mortgage, which would include an assignment of rents and profits. These requirements were satisfied by the documents which were used to formalize the transaction.

The evidence, however, supports the government's contention that this transaction was not a bona fide sale creating a debtor-creditor relationship. In *Burr Oaks Corp.* v. *Commissioner,* 365 F.2d 24 (7th Cir. 1966), the Court of Appeals affirmed the holding of the Tax Court that the transaction therein involved was a Section 351 transfer. In that case, three individuals transferred land to the taxpayer corporation in return for two year six per cent promissory notes in the amount of $110,000.00.

The form of the transaction was that of a sale, and at various times purported payments were made on the notes. There were several factors which led to the holding that the transaction was, in substance, an equity transaction. First, the corporation was organized with a paid-in capital of only $4,500.00, but shortly thereafter reflected a liability of $360,000.00—representing the value of the purported debt. Next, the land was the corporation's only asset. Third, the corporation had to borrow money to meet certain development costs. Lastly, the payment of notes was dependent upon the success of the business. 365 F.2d at 25-27.

This case presents a strikingly similar fact pattern. Stanley, Inc. was organized with a paid-in capital of $4,500.00, and at the time of the transfer had only $99.84. Immediately following the transfer in question, Stanley, Inc. showed a liability of $247,000.00—representing the value of the note given to Turkey Run, Inc. The land was the corporation's only visible asset and the payment of the alleged debt was subject to the success of the business. Stanley, Inc. had to borrow, as did Burr Oaks Corporation, to meet certain development costs. It thus appears that the entire risk of the venture was Turkey Run's. Though plaintiff contends that Turkey Run was protected by its mortgage, the evidence showed that by 1963 this protection had dissipated due to the release of individual parcels to buyers. By the end of 1963, when all but ten of the individual lots were sold, virtually all of the forty-one acres had been released from the mortgage, though $187,000.00 was still outstanding on the note. Further proof that Turkey Run, Inc. bore the entire risk is evidenced by the fact that Turkey Run, Inc. subordinated its interests to that of another creditor, Concrete Construction Company.

In *Portland Oil Co.* v. *Commissioner*, 109 F.2d 479, (1st Cir. 1940), it was said that a Section 351 transfer:

> lacks a distinguishing characteristic of a sale, in that, instead of the transaction having the effect of terminating . . . the beneficial interests of the transferor in the transferred property, . . . the transferors continue to be beneficially interested in the transferred property. . . .

No clearer example of a continuing beneficial interest could be found than that demonstrated by the facts of this case.

Under the tests laid down in *Burr Oaks Corp., supra, Kolkey, supra, Nassau Lens Co., Inc.* v. *Commissioner*, 308 F.2d 39 (2d Cir. 1962), *Camp Wolters Enterprises* v. *Commissioner*, 230 F.2d 555 (5th Cir. 1956), and *Gooding Amusement Co.* v. *Commissioner*, 236 F.2d 159 (6th Cir. 1956), and upon consideration of the facts discussed above, the Court finds that the transfer of land from Turkey Run, Inc. to Stanley, Inc. on November 13, 1962, was in the nature of an equity contribution and will be so treated for federal income tax purposes.

The next determination must be whether after the exchange the transferor was in control of Stanley, Inc. within the purview of Section 368(c). It is defendant's contention that Turkey Run, Inc. and Dr. Robert E. S. Young should be considered together as transferors and that immediately after the exchange they, together, were in control of Stanley, Inc. Stated otherwise, defendant contends that Dr. Young's purchase of all the voting shares of Stanley, Inc. and Turkey Run, Inc's loan, which completed the equity investment in Stanley, Inc., should be considered as one integrated transaction. Both parties cite and rely on *American Bantam Car Co.*

v. *Commissioner*, 11 T.C. 397, aff'd 177 F.2d 513 (3d Cir. 1949), wherein the Tax Court listed the following factors as being worthy of consideration in determining whether a series of steps may or should be treated as a single transaction: the intent of the parties, the time lapse, the ultimate result and the mutual interdependence of the steps.

If two or more persons transfer property to a corporation at the same time, or pursuant to a common scheme, the transfers can be considered together for federal income tax purposes. *Burr Oaks Corp.* v. *Commissioner, supra*; *Camp Wolters Enterprises v. Commissioner*, 230 F.2d 555 (5th Cir. 1956). In this case, it is clear that Dr. Young's transfer of cash to Stanley, Inc. in 1958 was a transfer of property within the meaning of Section 351. *American Bantam Car Co.* v. *Commissioner, supra.* Furthermore, the law is clear that the "stock or securities," of whatever form, received by the several transferors do not have to be identical to satisfy Section 351. Specifically, even though one transferor receives all of the voting stock and the other only equity, the requisite control will be determined to be held by both transferors together—resulting in a carryover basis in the property—as long as the transfers can be considered together. *Burr Oaks Corp.* v. *Commissioner, supra.* Therefore, in this case, if Dr. Young and Turkey Run, Inc. are both considered to be transferors they will be found to be in control of Stanley, Inc., for they owned more than eighty per cent of the voting stock of Stanley, Inc.

Turning to the factors as outlined in *American Bantam*, the Court finds that the defendant's contention is supported by the evidence.

Intent of the Parties. Plaintiff contends that there is

no evidence that the parties intended a mere change in the form of ownership of the subject property; however, based on what is discussed above, the Court decides that what occurred was not a true sale but more closely resembled a mere change in the form of ownership.

The Ultimate Result. Plaintiff contends, and rightly so, that the "control test" is not met in every transaction where the transferred property is the source of the purchase money. Plaintiff also contends that the benefits from the utilization of the land did transfer from Turkey Run, Inc. to Stanley, Inc. in that all that Turkey Run, Inc. received was the fair market value of the land. While the fact that the transferred property is the source of the purchase money is not controlling in every case, it has particular significance in light of the determination that this transaction was not a bona fide sale. Whether the parties to this transaction intended to shield the assets of Turkey Run, Inc. from the burdens and pitfalls of development or to allow Turkey Run, Inc. to claim capital gains treatment for the income from the purported sale, the ultimate result is that Turkey Run, Inc. did bear the risks of this development and did benefit, by being paid, from the utilization of the land. The prior financial condition of Stanley, Inc. dictates a finding that it was only through the utilization of the land that Turkey Run, Inc. would or could be paid.

Time Lapse and Interdependence of the Steps. Although the time lapse between the issuance of stock by Stanley, Inc. for cash received from Dr. Young and the issuance of an equity interest in the form of a promissory note to Turkey Run, Inc. was about four years, the defendant contends that these two transactions were so completely interdependent as to constitute a single trans-

fer within the meaning of Sections 351 and 368. It is clear that to fall within these sections it is not necessary that the transfer be singular and that multiple transfers need not occur at the same time. *Burr Oaks Corp.* v. *Commissioner,* 365 F.2d 24, 28 (7th Cir. 1966), *Camp Wolters Enterprises* v. *Commissioner,* 230 F.2d 555, 559 (5th Cir. 1956).

In *Camp Wolters, supra,* the Court found that separate transfers of property to the corporation in return for notes were "an integral part of the scheme of its forming and financing." 230 F.2d at 559. Further, this Court determines that the fact that the transactions in *Camp Wolters* took place within a time span of a few days does not sufficiently distinguish it from this case so as to require a contrary result. Although Stanley, Inc. had been incorporated four years before this transfer of land from Turkey Run, Inc., it had not been "fully formed and launched" in a business sense until the subject transaction occurred. *Id.*

The evidence is clear that prior to the subject transfer Stanley, Inc. was not financially capable of doing business and in effect the acquisition of land from Turkey Run, Inc. was the capitalization which gave life to it.

Since these transfer are, therefore, to be considered as one, and since each transferor received either stock or securities, the control test in Section 368(c) has been met. The Court determines, therefore, that the transfer of land from Turkey Run, Inc. to Stanley, Inc. was a Section 351 transfer resulting in a carryover basis for the land in the hands of Stanley, Inc.

B. Ordinary Income Or Capital Gain

The facts relating to the subsequent subdivision, development and sale of the land transferred from Turkey

Run, Inc. to Stanley, Inc. as presented by plaintiff during the trial are not disputed by the defendant. The dispute arises as to what issue is presented to the Court for determination.

Plaintiff contends that Stanley, Inc. is not and has not been engaged in the business of real estate development, and that the question presented is whether the activities of an independent contractor-developer can be attributed to the landowner for the purpose of finding that the landowner held the land primarily for sale to customers in the ordinary course of its trade or business. Defendant contends, on the contrary, that the question presented is whether Stanley, Inc. acquired the land and held the land for the sale to customers in the ordinary course of business so as to preclude capital gain treatment.

Section 1221 of the Internal Revenue Code of 1954 states:

> For purposes of this subtitle, the term "capital asset" means property held by the taxpayer . . ., but does not include:
>
> (1) stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business.

Plaintiff contends, and the evidence supports the fact that, Stanley, Inc.'s activities relating to the actual subdivision, development and sale of Greenfield Estates were minimal. The cases cited and relied upon by plaintiff demonstrate, however, that this is not the sole factor in the determination of whether income from the sale of real estate qualifies for capital gain treatment.

In *Voss* v. *United States*, 329 F.2d 164 (7th Cir. 1964) and *Smith* v. *Dunn*, 224 F.2d 353 (5th Cir. 1955) the taxpayers had owned or held the real estate for periods of twenty-three and fifty-three years respectively. *Gudgel* v. *Commissioner*, 273 F.2d 206 (6th Cir. 1959) also indicates that other factors play a part, for in that case the taxpayer, although an active participant in the development and sale of the real estate was accorded capital gain treatment for the income upon the Court's consideration of, (1) the purpose for which the property was acquired, (2) the time period during which the land was held, and (3) the circumstances leading to the sale.

This Court, therefore, does not interpret Section 1221 to mean that only by engaging in the business of real estate development may one be found to be holding realty for the sale to customers in the ordinary course of business.

> The term "capital asset" is construed narrowly in accordance with the purpose of Congress to afford capital gains tax treatment only in situations involving the realization of appreciation in value accrued over a substantial period of time, and thus to ameliorate the hardship of taxation of the entire gain in one year. *C.I.R.* v. *Gillette Motor Trans. Inc.* 364 U.S. 130 (1960).

Without passing on the question of whether the actions of DeNune Realty Company and Homewood, Inc. are attributable to Stanley, Inc., the Court finds that Stanley, Inc. held the land in question for sale to customers in the ordinary course of its business. Two factors, supported by the evidence, require this finding. First, Stanley, Inc., prior to the time it acquired this land, was engaged in no other business. Second, within

one week of acquiring the land, it contracted with DeNune Realty Company and Homewood, Inc. for the subdivision, development and sale of the land. It is obvious to this Court that Stanley, Inc. acquired this land for the purpose of sale, held it for the purpose of sale, and did, in fact, sell it to customers in the ordinary course of its only business activity, and that such activity does not comport with the Congressional intent in providing the capital gains exception to the normal tax laws. *Commissioner* v. *Gillette Motor Trans. Inc.*, *supra*.

II. ABANDONMENT LOSS

The second issue presented by this case is whether plaintiff is entitled to take a deduction, during the year 1963, for a loss occasioned by the abandonment of certain architectural plans.

The evidence disclosed that sometime prior to August 12, 1958, Turkey Run, Inc. planned to build a multiple dwelling apartment house complex on land owned by it. Pursuant to this plan, plaintiff, in consideration of having the exclusive right to manage the complex, agreed to obtain financing for the project. In its effort to obtain such financing, plaintiff entered into a contract with the architectural firm of Brown, Brubaker & Brandt for the rendering of preliminary and working drawings and for supervision of the actual construction of the project at an estimated cost of $67,000.00.

At the time this contract was entered into, namely August 12, 1958, the architects had already been paid $14,750.00 by Certified Mortgage Corporation. In time the remaining $52,750.00 due to the architects and $2,198.00 due to two engineering companies was paid by Certified Mortgage. At first, Dr. Robert Young gave his

personal note or notes to Certified Mortgage to secure this debt. However, on January 11, 1961, Stanley, Inc. gave its note to Certified Credit Corporation who succeeded to the interests of Certified Mortgage. This note was co-signed by Milher, Inc., a corporation owned by Dr. Young. Milher, Inc. pledged five per cent thrift certificates of Certified Credit in the amount of $70,000.00 to secure its note, and eventually these were redeemed in satisfaction of the note. Thereupon, Stanley, Inc. issued its note in the amount of $70,000.00 to Milher, Inc.

In November, 1961, the City Council of Columbus changed the zoning regulations governing the property owned by Turkey Run, Inc. so that the proposed apartment house complex could not be built. Efforts, including the filing of a law suit against the city, were made to have the land rezoned to allow multiple dwelling construction. While the evidence is conflicting, the Court finds that during the last week of December, 1963, the decision was made to dismiss the suit against the city and to cease efforts to change the zoning.

Plaintiff contends that all efforts to change the zoning were abandoned in 1963, and that in that year it is entitled to a loss of $69,698.75 on its note to Milher, Inc. Defendant, on the other hand, claims that Stanley, Inc. suffered no loss because: (1) it had no "property," the termination of the usefulness of which would give rise to a loss; (2) the plans are depreciable property whereas abandonment relates only to non-depreciable property; (3) there was no abandonment of the plans; (4) that Stanley, Inc. has a right to recover from Turkey Run, Inc. if it ever pays off the note; and, (5) if there were a loss, it occurred in 1961, not 1963.

Section 165 of the Internal Revenue Code of 1954, states:

(a) *General Rule*—There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

The applicable treasury regulation—T.R. 1.165-1(b) states:

> *Nature of loss allowable.* To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transaction, fixed by identifiable events, and, . . . actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

Looking at the matter with regard to substance rather than form, the Court finds from the evidence that the plaintiff owned a set of architect's plans valued at $67,000.00, subsequently these plans became valueless, plaintiffs made efforts to mitigate the loss and late in 1963, plaintiff ceased these efforts. The evidence does not suggest, as defendant argues, that plaintiff never intended to pay the note issued to Milher, Inc. which forms the basis for this loss deduction. The evidence does support plaintiff's claim for an abandonment loss in 1963, and therefore, the deduction was erroneously disallowed.

WHEREUPON, upon consideration of evidence presented through the testimony of the witnesses, exhibits and depositions and the cases herein cited, it is the determination and judgment of the Court that:

1. The transfer of land from Turkey Run, Inc. to Stanley, Inc. was a Section 351 transfer resulting in a carry-over basis for the land in the hands of Stanley, Inc.
2. The income to Stanley, Inc. from the sale of Greenfield Estates is ordinary income.

3. Stanley, Inc. suffered a deductible loss in 1963 from the abandonment of the architectural plans proposed for it by Brown, Brubaker and Brandt.

Settle an Order consistent herewith on or before twenty (20) days from the date hereof.

/s/ JOSEPH P. KINNEARY
United States District Judge

STATUTORY PROVISIONS INVOLVED

Section 351 (a) Internal Revenue Code (1954) (26 U.S.C. Sec. 351, 1964 ed):

GENERAL RULE.—No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock or securities in such corporation and immediately after the exchange such person or persons are in control (as defined in section 368 (c)) of the corporation. For purposes of this section, stock or securities issued for services shall not be considered as issued in return for property.

Section 368 (c) Internal Revenue Code (1954) (26 U.S.C. Sec. 368, 1964 ed):

CONTROL.—For purposes of part I (other than section 304, part II and this part, the term "control" means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation.